Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:STP:POSTF-139416-02
Ejohnson

date: SEP 10 2002

to: Ann Layton, LMSB Team Manager

from: ERIC JOHNSON
Senior Attorney, LMSB Counsel Area 3

subject: **Tax Matters Partner** [redacted]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum is in response to your request for advice dated July 19, 2002.

This memorandum is being sent to Chief Counsel National Office for 10-day post-issuance review. In the event National Office wishes to make changes to this advice, the undersigned will contact you within 10 days of issuance.

ISSUES

1. Whether the Service correctly selected a domestic limited partner as the tax matters partner for a TEFRA partnership in place of a foreign general partner.

2. If the Service incorrectly selected the domestic limited partner as the tax matters partner, whether the Service may select one of the domestic limited partners as the tax matters partner if the foreign general partner resigns as the tax matters partner.

CONCLUSIONS

1. The Service incorrectly selected the domestic limited partner as the tax matters partner. A follow-up letter should be issued to clarify the situation.

2. If the foreign general partner resigns as the tax matters

partner (without designation of a new tax matters partner by the foreign general partner or the partnership), the Service may select one of the domestic limited partners as the tax matters partner, assuming that the foreign general partner is not engaged in a trade or business within the United States and does not otherwise maintain an active presence in the United States, e.g. does not have an individual authorized to act on its behalf as the tax matters partner that is resident in the United States. There are substantial legal hazards to this conclusion.

FACTS

The partnership under examination is the [redacted] ('[redacted]'). [redacted] is organized under the laws of Delaware. [redacted] was formed to construct and manage resort property in [redacted]. The tax years under examination are tax years [redacted], [redacted], and [redacted].

[redacted] filed Form 1065 for each of the tax years under examination. According to the filed Schedules K-1, the partners of [redacted] were as follows. [redacted] ('[redacted]') is a general partner organized under foreign law.[1] The other partners are all limited partners - [redacted] ('[redacted]'), [redacted] ('[redacted]'), and [redacted] ('[redacted]'). [redacted] is organized under the laws of [redacted], has made a check-the-box election to be treated as a corporation for purposes of federal income tax, and is a member of the consolidated group of corporations with the parent [redacted] ('[redacted]'), [redacted] and CIC taxpayer. [redacted] is organized under the laws of [redacted] and is wholly owned by [redacted], a member of the consolidated group of corporations with the parent [redacted]. [redacted] is organized under foreign law.

[redacted] is subject to the TEFRA examination provisions, I.R.C. §§6221 et seq., for the tax years under examination (because [redacted] had one or more partners that are not individuals or C-corporations, see, I.R.C.

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[1] It is not clear from the submitted information whether [redacted] is a corporation for purposes of federal income tax. [redacted] organized under the law of the Netherlands is generally a corporation for purposes of federal income tax, but there are 'grandfather' exceptions. See, Reg. §301.7701-2(b)(8) and (d). The difference does not seem relevant to the analysis in this memorandum.

§6231(a)(1)(B)(i)).[2]

[redacted] on the filed Form 1065 for each of tax years [redacted], [redacted], and [redacted] designated [redacted] as the tax matters partner.

On or about May 21, 2002, the examination team, through the Team Manager, issued a letter to all the partners of [redacted]. The letter stated as follows:

> Re: Designation of Tax Matters Partner - [redacted] [EIN omitted]
>
> Dear Sir or Madam:
>
> The purpose of this letter is to designate a "tax matters partner" for the above named partnership. [redacted], [EIN omitted] **has been designated as the "tax matters partner."** Notification is made pursuant to Internal Revenue Code Section 6231(a)(7).
>
> Review of the partnership return, Form 1065, for the above named partnership, showed that the general partner named as the "tax matters partner", [redacted], is a foreign partner residing outside the United States. Internal Revenue Code Section 6231 and the regulations for that section prescribe that the commissioner has authority to designate a "tax matters partner" when the general partner is disqualified. Residence of the partner outside the United States or its possessions is one of the items causing disqualification. Delegation Order 209(Rev.4) updated 10-02-2000 delegates this authority to Team Managers. In considering which partner to designate as the "tax matters partner" the first consideration was that the partner had to be a domestic partner. Discussion with [redacted], who signed the partnership return in his capacity as Vice President of Tax, [redacted], member of [redacted], General Partner, indicated that [redacted], was the only non-tiered partner and the most knowledgeable about tax matters of the partnership. Based on this and the partner's access to the books and records the decision was made to select [redacted], as the "tax matters partner" in lieu of using the profits interest as the criteria.

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[2] This memorandum accepts as a given that [redacted] is subject to the TEFRA provisions for the tax years at issue. The undersigned has not analyzed this issue.

If you have any questions please call me at [omitted].

[Team Manager]

ANALYSIS

issue 1

The Service incorrectly selected [redacted] as the tax matters partner.

The TEFRA regulations on designation/selection of a tax matters partner may be divided into two parts. The first part, Reg. §301.6231(a)(7)-1(a) through (l), addresses designation of the tax matters partner by the partnership. The second part, Reg. §301.6231(a)(7)-1(m) through (r), addresses selection of the tax matters partner by the Service where the partnership has made no designation, or where the partnership designation has terminated within the meaning of Reg. §301.6231(a)(7)-1(l) without designation of a new tax matters partner by the partnership or the tax matters partner.

A partnership may designate only a general partner as the tax matters partner. Reg. §301.6231(a)(7)-1(b). If the partnership has several general partners, it must *prefer* domestic general partners over foreign general partners.

> *Limitation on designation of tax matters partner who is not a United States person.* If any United States person would be [as a general partner] eligible ... to be designated as the tax matters partner of a partnership for a taxable year, no person who is not a United States person may be designated as the tax matters partner of the partnership for that year without the consent of the Commissioner.

Reg. §301.6231(a)(7)-1(b)(2). A United States person includes a "domestic partnership" and a "domestic corporation", I.R.C. §7701(a)(30), and "domestic" is defined as "created or organized in the United States or under the law of the United States or of any State ... ," I.R.C. §7701(a)(4).

However, where, as in this case, the only general partner is a foreign entity or individual, the quoted limitation of Reg. §301.6231(a)(7)-1(b)(2) does not prevent the designation by the partnership of the foreign entity or individual as the tax matters partner. Nor in such a situation does any other provision of Reg. §301.6231(a)(7)-1(a) through (l) prevent the partnership from designating the foreign entity or individual as the tax matters partner.

The provision implicitly relied upon by the Service in the issued letter is Reg. 301.6231(a)(7)-1(o)(3)(iii), which disqualifies a partner that "is residing outside the United States ... ." The provision, however, as indicated above, is in the part of the regulations concerning the selection of the tax matters partner by the Service where the partnership has made no designation, or where the partnership designation has terminated without designation of a new tax matters partner by the partnership or the tax matters partner. It does not operate to disqualify a tax matters partner designated by the partnership.

Because the Service's selection of [redacted] was contrary to the regulations, the issued letter is likely null and void and [redacted] is currently the legal and valid tax matters partner. However, if the matter is not clarified, the Service may later through estoppel principles be prevented from disputing that [redacted] is the tax matters partner, which could have detrimental results, e.g. with respect to extensions of the statute of limitations. See, e.g., Benoit v. Commissioner, 25 T.C. 656 (1955), vacated on other grounds, 238 F.2d 485 (1st Cir. 1956); Cascade Partnership v. Commissioner, T.C. Memo. 1996-299. A follow-up letter should therefore be issued to retract the issued letter. The following language for the follow-up letter is suggested.

> Re: Prior Purported Selection of a Tax Matters Partner - [redacted] [EIN]
>
> This letter follows the letter of May 21, 2002, in which the Internal Revenue Service purported to select [redacted], [EIN] in place of [redacted], [EIN] as the tax matters partner for the above named partnership.
>
> The basis for the Service's purported selection was that the tax matters partner as designated by the partnership, [redacted], is a foreign entity and as such is disqualified from serving as a tax matters partner pursuant to Reg. §301.6231(a)(7)-1(o)(3)(iii), which disqualifies a partner that "is residing outside the United States, its possessions, or territories" from serving as a tax matters partner.
>
> The basis for the Service's purported selection was legally incorrect. Reg. §301.6231(a)(7)-1(o)(3)(iii) operates to disqualify a partner from serving as a tax matters partner in the context of a situation where the Service must select a tax matters partner because no tax matters partner has been designated by the partnership, or because the tax matters partner designated by the partnership has terminated

(without designation of a new tax matters partner by the partnership or the tax matters partner) within the meaning of Reg. §301.6231(a)(7)-1(l). This situation was not present in this case. The partnership had designated a tax matters partner, and the Service is not aware of any termination of that designated tax matters partner.

Because the Service's purported selection of a new tax matters partner by the letter of May 21, 2002, was contrary to the regulations, the Service takes the position that this letter was null and void *ab initio* and without legal effect, and that the letter did not terminate or interrupt the status of [redacted], as tax matters partner for the partnership.

issue 2

If [redacted] resigns as the tax matters partner, within the meaning of Reg. §301.6231(a)(7)-1(l)(v)(A), without designation of a new tax matters partner by [redacted] or [redacted], the Service may select one of the domestic limited partners as the tax matters partner, assuming that [redacted] is not engaged in a trade or business within the United States and does not otherwise maintain an active presence in the United States, e.g. does not have an individual authorized to act on its behalf as the tax matters partner that is resident in the United States.[3]

If the tax matters partner designated by the partnership terminates as the tax matters partner, within the meaning of Reg. §301.6231(a)(7)-1(l), the Service must determine that the general partner that has the largest profits interest is the new tax matters partner. Reg. §301.6231(a)(7)-1(m)(1)(ii) and (2).

If the termination of the tax matters partner is the result of one of the events described in Reg. §301.6231(a)(7)-1(l)(i) through (iv), generally the death or dissolution of the tax matters partner, the terminated tax matters partner is ignored for purposes of applying the largest-profits-interest test. Reg. §301.6231(a)(7)-1(m)(3). See, Barbados #7, Ltd. v. Commissioner, 92 T.C. 804 (1989). However, if the termination is through

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[3] The analysis and conclusions of this opinion apply generally in the same manner if the status of [redacted] as the tax matters partner is revoked by [redacted], within the meaning of Reg. §301.6231(a)(7)-1(l)(v)(C), without designation of a new tax matters partner by [redacted].

resignation of the tax matters partner under Reg. §301.6231(a)(7)-1(l)(v)(A), nothing in the regulations excludes the prior tax matters partner from being considered in applying the largest-profits-interest test. Thus, if the tax matters partner that is also the general partner with the largest profits interest resigns, the Service is generally required to determine that that partner is the new tax matters partner.

The Service is not required to determine that the general partner with the largest profits interest is the tax matters partner if application of the largest-profits-interest test is impracticable as defined in Reg. §301.6231(a)(7)-1(o). Application of the largest-profits-interest test is impracticable if the general partner with the largest profits interest is disqualified. Reg. §301.6231(a)(7)-1(o)(3). The general partner with the largest profits interest is disqualified if the general partner

> (i) Has been notified of suspension from practice before the Internal Revenue Service;
> (ii) Is incarcerated;
> (iii) Is residing outside the United States, its possession, or territories;
> (iv) Cannot be located or cannot perform the functions of a tax matters partner for any reason, except that lack of cooperation with the Internal Revenue Service by the general partner with the largest profits interest is not a basis for finding that the partner cannot perform the functions of a tax matters partner.

Reg. §301.6231(a)(7)-1(o)(3). When the general partner with the largest profits interest is thus disqualified, and there is no other general partner, the Service is authorized to select a limited partner as the tax matters partner. Reg. §301.6231(a)(7)-1(p)(3)(ii). In selecting a limited partner to replace a disqualified tax matters partner, the Service "may" take into account the following criteria:

> (i) The general knowledge of the partner in tax matters and the administrative operation of the partnership.
> (ii) The partner's access to the books and records of the partnership.
> (iii) The profits interest held by the partner.
> (iv) The views of the partners having a majority interest in the partnership regarding the selection.
> (v) Whether the partner is a partner of the partnership at the time the tax-matters-partner selection is made.
> (vi) Whether the partner is a United States person ... .

Reg. §301.6231(a)(7)-1(q)(2). The use of the word "may" indicates that these criteria are not legally binding, and that the Service is given a large degree of discretion in selecting one of the limited partners as the tax matters partner.

There is little or no case law or published Service guidance that addresses the disqualification provisions of Reg. §301.6231(a)(7)-1(o)(3). Most of the bases for disqualification seem to contemplate an *individual* tax matters partner, not an entity, e.g. only an individual generally can be suspended from practice before the Service (only an individual may be authorized to practice before the Service, see, 31 C.F.R. §10.3) or incarcerated.

The phrase "residing outside the United States" also seems directed at an individual tax matters partner. Under the general terminology of the Code and tax law, individuals "reside", whereas entities are "organized under the laws of" a particular jurisdiction. See, I.R.C. §7701(a)(4) and (30), cited above. In other areas of the law, the term "reside" is generally applied to individuals rather than entities. See, "reside" and "residence", Black's Law Dictionary, 1473 (4th rev.ed. 1968).

However, there is and has been reference in tax law to "resident" entities. The predecessor to I.R.C. §882, §231 of the 1939 Code, imposed federal income tax on foreign corporations that were "resident corporations" with respect to the United States. The test for a "resident corporation" was essentially the same as the current standard under I.R.C. §882 for taxation of a foreign corporation - that the foreign corporation is engaged in a trade or business within the United States. Reg. §301.7705-5 also provides a definition of a "resident" entity as one that is engaged in a trade or business in the United States. There is at least one area where a finding of a "resident" entity is still relevant to federal income tax. Reg. §1.861-2(a)(1) provides that interest is domestic-source income if received from a United States "resident" and under Reg. §1.861-2(a)(2), a United States "resident" includes *inter alia* a foreign corporation or partnership engaged in a trade or business within the United States.

In this case, if [redacted] is not engaged in a trade or business in the United States, and does not otherwise maintain an active presence in the United States, e.g. does not have an individual authorized to act on its behalf as the tax matters partner that resides in the United States, it is likely that a court would uphold the Service's determination that [redacted] is disqualified from consideration as a tax matters partner under Reg. §301.6231(a)(7)-1(o)(3)(iii) and

(iv), and uphold the Service's selection of one of the domestic limited partners as the tax matters partner.[4]

(b)(5)(DP)

[redacted]

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[4] It should be noted that if [redacted] is engaged in a trade or business within the United States, [redacted] is generally treated as engaged in a trade or business within the United States for purposes of I.R.C. §882. See, I.R.C. §875(1); Reg. §1.875-1; United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956), cert. den., 352 U.S. 986 (1957). It is unclear, however, whether this means, if [redacted] is engaged in a trade or business within the United States, and [redacted] is not, that [redacted] should be considered a resident of the United States under Reg. §301.6231(a)(7)-1(o)(3)(iii). The fact that [redacted] is organized under United States law (Delaware) is likely irrelevant to whether [redacted] should be considered a resident of the United States under Reg. §301.6231(a)(7)-1(o)(3)(iii). A partnership organized under United States law is not thereby a resident of the United States. See, Reg. §1.861-2(a)(2)(iii) and (iv) and Reg. §301.7701-5 last sentence. (A corporation organized under United States law, however, is thereby a resident of the United States. See, Reg. §1.861-2(a)(2)(ii) and Reg. §301.7701-5 ("A domestic corporation is a resident corporation even though it does no business and owns no property in the United States."))

(b)(5)(DP) [redacted] .

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By:_____
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